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October 29, 2018

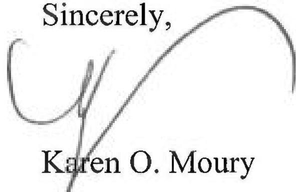
Via Electronic Filing
Rosemary Chiavetta, Secretary
PA Public Utility Commission
PO Box 3265
Harrisburg, PA 17105-3265

Re: Pennsylvania Public Utility Commission v. PECO Energy Company, Docket Nos. R-2018-3000164

Dear Secretary Chiavetta:

Enclosed for electronic filing please find NRG Energy, Inc.'s Exceptions with regard to the above-referenced matter. Copies to be served in accordance with the attached Certificate of Service.

Sincerely,



Karen O. Moury

KOM/lww
Enclosure

cc: Hon. Christopher P. Pell w/enc.
Hon. F. Joseph Brady w/enc.
Office of Special Assistants w/enc. (ra-OSA@pa.gov)
Cert. of Service w/enc.

{L0783662.1}

CERTIFICATE OF SERVICE

I hereby certify that this day I served a copy of NRG Energy's Exceptions upon the persons listed below in the manner indicated in accordance with the requirements of 52 Pa. Code Section 1.54.

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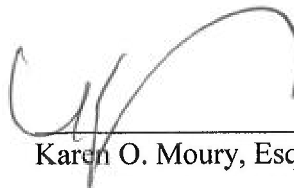

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BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

Pennsylvania Public Utility Commission Office of Consumer Advocate Office of Small Business Advocate v. PECO Energy Company	: : : : : : :	R-2018-3000164 C-2018-3001112 C-2018-3001043

EXCEPTIONS OF NRG ENERGY, INC.

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I. INTRODUCTION AND SUMMARY OF EXCEPTIONS

NRG Energy, Inc. ("NRG") respectfully urges the Pennsylvania Public Utility Commission ("Commission") to modify the Recommended Decision ("RD") issued by the Office of Administrative Law Judge ("OALJ") to rectify the misallocation of over $100 million of costs by PECO Energy Company ("PECO"). Due to its flawed cost allocation approach, PECO is charging distribution rates that are too high and charging a price to compare ("PTC") for default service that is too low. For over twenty years, the Commission has expressed a desire to get these cost allocations correct so that electric distribution companies ("EDCs") are recovering the costs of providing default service through their PTCs rather than through distribution charges. Indeed, the Commission has invited interested parties to present evidence in distribution rate cases to rectify this long-standing and persistent problem.

In PECO's distribution rate proceeding, NRG stepped up to the plate, intervened (over the opposition of PECO) and took the unprecedented step of presenting expert witness testimony by a forensic accountant/certified public accountant to demonstrate the flaws inherent in PECO's proposed cost allocation approach. Further, NRG did not just point out the problem; it also proposed a detailed solution. Through testimony, NRG offered an alternative cost allocation approach, based on widely accepted accounting principles and standard business practices across a wide variety of industries. Under NRG's proposal, PECO's distribution charges and its PTC for default service would be adjusted so that they more accurately reflect the costs that are incurred to provide these services. Importantly, NRG's cost allocation proposal is also consistent with the Commission's regulations governing default service and reflects the unbundling standard adopted by the Commission in 1997 of producing results that resemble the

scenario under which PECO provides default service and distribution service through functionally separate divisions.[1]

With cursory analysis and declining to afford any level of respect for the cost allocation expertise of NRG's expert witness, the RD dismisses NRG's proposal through a discussion that spans a handful of pages and is primarily focused on accepting PECO's position. In condoning PECO's misallocation of costs, the RD ignores irrefutable facts highlighted by NRG and disregards well-established law, along with persuasive Commission precedent. NRG's position, rationale and proposal warrant thoughtful consideration and full analysis by the Commission. Through modification of the RD to adopt NRG's alternative cost allocation proposal, the Commission can finally begin to rectify the misallocation of costs that has persisted for over twenty years and interferes with the proper functioning of the competitive electric retail market.

Consistent with the framework established by the Public Utility Code and Commission regulations, PECO operates two separate and distinct businesses of:

> (1) providing distribution services, as the EDC or "wires" company, which involves delivering electricity to retail customers; and
>
> (2) furnishing default service, as the default service provider ("DSP"), which entails supplying electricity to retail customers who are not being served by an electric generation supplier ("EGS").

Despite the operation of these two separate and distinct businesses, PECO allocates *all* indirect expenses associated with the residential classes to the segment of its business that provides residential distribution service and allocates *zero* indirect expenses to the side of its business that furnishes residential default service.

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[1] *Application of PECO Energy Company for Approval of its Restructuring Plan Under Section 2806 of the Public Utility Code*, Docket No. R-00973953 (Order entered December 23, 1997) ("*1997 Restructuring Order*"), at 53-58. A relevant excerpt of the 1997 Restructuring Order was included as NRG Exhibit CP-4.

Indirect expenses are costs that cannot be directly linked with a particular service or product, including overhead costs, such as A&G expenses. Chris Peterson, a forensic accountant/certified public accountant and NRG's expert witness in this proceeding, explained that under widely accepted accounting principles, it is standard business practice across a variety of industries to allocate indirect costs (also known as shared or common costs) to different segments or lines of a business. This assertion was not refuted by either PECO or the Office of Consumer Advocate ("OCA") – the only parties who submitted responsive testimony. Indeed, the Commission itself follows these accounting principles and uses a percentage of revenues approach to allocate indirect costs, which are not directly attributable to any particular industry group, among the industries it regulates. While indirect costs cannot, by their very nature, be attributed to particular aspects of an entity's operations, Mr. Peterson emphasized that a reasonable level of administrative expenses is necessary to support any business' operations.

It is indisputable that PECO's failure to allocate indirect costs across both separate and distinct segments of its operations is a departure from widely accepted accounting principles and standard business practices of a variety of industries. Because PECO allocates no indirect expenses to the default service side of its business, its PTC reflects zero information technology ("IT") costs, zero regulatory commission costs and zero consumer education costs. Notably, this means that PECO is supposedly operating a business upon which over one million residential customers rely for supply service without incurring any IT costs. It is unfathomable to accept the notion that PECO incurs no IT costs to provide essential electricity services as the default service provider for two-thirds of its residential customers. Indeed, PECO's entire "administrative costs" to run this massive default service business during the last quarter amounted to a mere $118,314. Astonishingly, PECO's current PTC reflects *negative* A&G expenses related to default service. Common sense dictates that it would be impossible to run any business, let alone

a business that is selling 8.6 billion kilowatt hours ("kWh") of electricity and projecting to collect over $637 million in annual revenues from the default service side of its business, with negative A&G expenses.

Also, as a result of PECO's misallocation of costs, it is proposing to recover a disproportionately high amount of its costs through residential distribution charges. When a reasonable portion of PECO's indirect costs is reallocated from residential distribution service to residential default service, PECO's revenues from distribution charges would be reduced by $101 million.[2] This would equate to an average reduction in residential distribution charges in the amount of .76 cents per kWh. More specifically, a residential customer using 1,000 kWh per month would see a decrease in his or her monthly distribution charges in the amount of $7.64, which would amount to $91.68 over the course of a year. Through the reallocation of $101 million in indirect costs from residential distribution service to residential default service, PECO would recover these costs through the PTC rather than through distribution rates. The effect of this reallocation, which relies on commonly utilized allocators of percent of revenues and number of customers, would be an increase in the PTC for residential default service from 7.15 cents per kWh to 8.40 cents per kWh, a 15 percent increase.

Importantly, because of PECO's failure to allocate any indirect costs to default service and its proposal to annually recover over one hundred million dollars of indirect costs through its distribution charges that should be recovered through its PTC for default service, it is providing misleading information to customers regarding the cost of default service. By establishing an artificially low PTC, PECO is depriving its default service customers of their right to receive fair and accurate information on a uniform basis – as required by the Public Utility Code and Commission precedent – that enables them to meaningfully compare prices charged by PECO

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2 This calculation uses proposed rates for the Fully Projected Future Test Year ("FPFTY") 2019.

for default generation service and prices offered by EGSs for competitive generation service. The lower PTC, which does not accurately reflect the costs of providing default service, also enhances PECO's ability to attract and retain default service customers, making it more difficult for EGSs to compete in the retail market.

In accepting PECO's flawed practice of allocating all indirect costs to the distribution side of its business, the RD engages in scant analysis and commits several errors. Specifically, the RD: (i) fails to hold PECO to the well-established burden of proving that it is just and reasonable to allocate all of its indirect costs associated with the residential classes to the distribution side of its business, and further errs in finding that PECO has met this burden; (ii) improperly finds that the PECO's PTC contains all of the necessary components, which it clearly does not since it reflects no indirect costs, *de minimus* administrative costs and *negative* administrative and general ("A&G") costs related to default service; (iii) disregards the standard previously established by the Commission for the unbundling of generation, transmission and distribution charges, as well as prior Commission directives for EDCs to remove costs related to default service that are embedded in distribution rates and recover them through the PTC; and (iv) adopts an avoided cost theory for cost allocation and ratemaking purposes without legal support or precedent and despite the Commission's prior rejection of this approach, thereby failing to apply traditional cost causation principles.

Through modifying the RD and directing PECO to allocate a reasonable portion of indirect costs to residential default service, consistent with widely accepted accounting principles and standard business practices across a variety of industries, the Commission would ensure that PECO's distribution charges are reduced to recover only those costs that are properly incurred to furnish residential distribution service. Further, as required by the Commission's regulations, these costs would instead be recovered through PECO's PTC for default service. In this manner,

consumers would have an opportunity to more meaningfully compare on a uniform basis the prices charged by PECO for default generation service with the prices offered by EGSs for competitive generation service. By directing the implementation of NRG's proposals, the Commission would also reduce the subsidization of default service by distribution customers and improve the overall functioning of the electric retail competitive market.

II. PROCEDURAL BACKGROUND

On March 29, 2018, PECO filed Tariff Electric-Pa. P.U.C. No. 6, in which it proposed rates designed to produce an increase in PECO's annual distribution revenue of approximately $82 million. NRG filed a Petition to Intervene on May 4, 2018, which was granted without limitation by Prehearing Order #2 issued by Deputy Chief Administrative Law Judge Christopher Pell and Administrative Law Judge F. Joseph Brady on June 1, 2018.[3] NRG adopts the remaining procedural history that is set forth in the "Background" section of the Joint Petition for Partial Settlement ("Settlement"), which was filed on August 28, 2018, and as described by the RD.[4]

On June 26, 2018, NRG served the Direct Testimony of Chris Peterson, which is marked as NRG St. No. 1, and was accompanied by NRG Exhibits C-1 through C-18. On August 8, 2018, NRG served the Surrebuttal Testimony of Chris Peterson, which is marked as NRG St. No. 1-SR (Rev), and was accompanied by NRG Exhibits C-19, C-20 (Rev), C-21 and C-22. These testimonies and exhibits, along with NRG Cross Examination Exhibit 1, were admitted into the record during the evidentiary hearing held on August 21, 2018.

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[3] NRG has five affiliate companies that are licensed by the Commission as EGSs to provide electricity or electric generation supply services to retail customers throughout Pennsylvania. These EGSs, which include Reliant Energy Northeast LLC d/b/a NRG Home and NRG Business, Green Mountain Energy Company, Energy Plus Holdings LLC, Independence Energy Group d/b/a Cirro Energy and XOOM Energy Pennsylvania, LLC, serve customers PECO's distribution service territory. NRG St. No. 1 at 3; NRG St. No. 1-SR (Rev) at 1.

[4] RD at 1-8.

As noted in the Settlement (pages 1-2), NRG opposes the Settlement only to the extent that is based on PECO's allocation of certain indirect costs to residential distribution service instead of residential default service, and the effect of reallocating those costs to residential default service, with a commensurate reduction in the level of residential distribution charges. This issue has been reserved for litigation by the parties.[5]

NRG filed its Main Brief on September 7, 2018 and filed its Reply Brief on September 17, 2018. The Recommended Decision was served on October 18, 2018. Exceptions are due by October 29, 2018. By these Exceptions, NRG fully incorporates by reference the arguments set forth in its Main Brief and Reply Brief.

III. EXCEPTIONS

A. EXCEPTION NO. 1: THE RD ERRS IN CONCLUDING THAT PECO CARRIED ITS BURDEN OF PROVING THAT IT IS JUST AND REASONABLE TO ALLOCATE ALL INDIRECT COSTS TO RESIDENTIAL DISTRIBUTION SERVICE WHILE ALLOCATING NO INDIRECT COSTS TO RESIDENTIAL DEFAULT SERVICE

1. *PECO Has Affirmative Burden to Prove that Its Proposed Rates Are Just And Reasonable*

It is well-settled that as the public utility requesting an increase in its distribution rates, PECO has the burden of proving the justness and reasonableness of every element of its requested rate increase. Section 315(a) of the Public Utility Code ("Code") provides that "the burden of proof to show that the rate involved is just and reasonable shall be upon the public utility. Further, the Commonwealth Court has held that Code Section 315(a) "places the burden of proving the justness and reasonableness of a proposed rate hike squarely on the utility. It is well-established that the evidence adduced by a utility to meet this burden must be substantial."[6]

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[5] The impact of NRG's proposal on the Settlement is that PECO would be recovering a portion of the agreed upon distribution revenue requirements for the residential class through the PTC for residential default service rather than through residential distribution rates.

[6] *Lower Frederick Twp. v. Pa. P.U.C.*, 48 Pa. Commw. 222, 226-27, 409 A.2d 505, 507 (1980) (citations omitted). *See also, Brockway Glass v. Pa. P.U.C.*, 63 Pa. Commw. 238, 437 A.2d 1067 (1981); NRG MB at 10-11.

Under Pennsylvania law, no similar burden is placed on a party proposing an adjustment to a utility base rate filing.[7] "In general rate increase proceedings...the burden of proof does not shift to parties challenging a requested rate increase. Rather, the utility's burden of establishing the justness and reasonableness of every component of its rate request is an affirmative one, and that burden remains with the public utility throughout the course of the rate proceeding."[8] The party proposing an adjustment to a ratemaking claim bears the burden only of "presenting some evidence or analysis tending to demonstrate the reasonableness of the adjustment."[9]

2. *PECO Allocates All Indirect Costs to One Side of Its Business*

It is undisputed that in its cost of service study ("COSS"), PECO allocates all indirect costs that are assigned to the residential customer classes to residential distribution service and allocates zero indirect costs to residential default service.[10] Indirect expenses are costs that are not directly linked with a particular service or product, including overhead costs, such as A&G expenses. NRG St. No. 1-SR (Rev) at 23-24. "While indirect costs cannot, by their nature, be attributed directly to certain aspects of PECO's operation," NRG's witness, Mr. Peterson, emphasized that a "reasonable level of administrative expenses" is "necessary to support any business' operations." NRG St. No. 1-SR (Rev) at 39. Particularly given that PECO provides default service to approximately 66 percent of the residential population in its service area, a reasonable portion of indirect costs must be allocated to support those operations. NRG St. No. 1-17. This is the same point that OCA's witness made during PECO's 1997 restructuring

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7 *PUC v. Appalachian Utilities, Inc.*, Docket No. R-2015-2478098 et al., (Opinion and Order entered March 10, 2016 adopting the Recommended Decision dated February 19, 2016), at 19, 2016 Pa. PUC LEXIS 62.

8 *Appalachian* at 19. *See also Berner v. Pa. P.U.C.*, 382 Pa. 622, 116 A.2d 7638 (1955) (Pennsylvania Supreme Court made it patently clear that it is the utility who bears the burden of proving the justness and reasonableness of every aspect of the rate request and that the burden never shifts to those challenging it).

9 *See, e.g., PUC v. Breezewood Telephone Company*, Docket No. R-901666, (Opinion and Order entered January 31, 1991), 1991 Pa. PUC LEXIS 45 *10; *PUC v. PECO*, Docket No. R-891364, et al., (Opinion and Order entered May 16, 1990).

10 NRG St. No. 1 at 15-17; NRG Exhibit CP-5; Tr. 451-452, 456.

proceeding, with which the Commission agreed – "[i]t is simply incorrect to allocate these dollars entirely to T&D."[11]

The provision of distribution service and default service are wholly separate and distinct functions that should be treated as such for purposes of allocating indirect costs, which are sometimes referred to as common or shared costs. Distribution service involves the delivery of electricity to retail customers by the EDC or "wires company,' while default service entails the provision of electric generation or supply service by the DSP to customers who have not chosen an EGS. NRG St. No. 1-SR (Rev) at 19. The Commission has explained the differences in these functions as follows:[12]

> The Competition Act deregulated electricity generation and provided all customers in Pennsylvania with the opportunity to choose their electricity generation supplier (EGS). 66 Pa. C.S. 2806 (a). The EDC is responsible for delivering the electricity to those customers who choose to buy from an EGS. Additionally, the EDC is responsible for both acquiring and delivering electricity for those customers who do not shop or buy their electricity from an EGS or where an EGS fails to provide the promised electricity.
>
> **When an EDC acquires electricity for customers not served by an EGS, the EDC is functioning as the "default service provider" (DSP).**

Notably, the regulations provide for the possibility of an entity other than the EDC serving in the DSP role, which is further evidence of the separate and distinct functions that EDCs and DSPs fulfill.[13] In addition, an EDC's distribution rates are established in a general rate case proceeding, whereas its default service rates are formulated during a separate default service proceeding.[14] Despite the clear differences between these two separate functions, the RD neither

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11 *1997 Restructuring Order* at 57, quoting OCA St. No. 5, p. 5.

12 *Implementation of Act 129 of October 15, 2008; Default Service And Retail Electric Markets*, Docket No. L-2009-2095604, Final Rulemaking Order at 2 (Oct. 4, 2011) (emphasis added).

13 52 Pa. Code § 54.183(b)-(d).

14 *See* 66 Pa.C.S. §§ 1308, 2807; *Petition of PECO Energy Company for Approval of its Default Service Program for the Period from June 1, 2017 through May 31, 2021*, Docket No. P-2016-2534980 (Order entered December 8, 2016).

accepts this premise nor explains why the OALJ views these two sides of PECO's business as being one in the same.[15]

3. *The RD Does Not Support the Conclusion that PECO Carried Its Burden of Proof*

The RD acknowledges that PECO has the burden of proof in this proceeding and that the evidence adduced by a utility to meet this burden must be substantial.[16] Despite recognition of this "formidable task,"[17] the RD concludes – without any discussion – that PECO has carried its burden.[18] Notably, the scant rationale, which appears in five pages of the 132-page RD, addressing the sole litigated issue in this proceeding, does not even reference PECO's burden of proof, let alone explain how PECO supposedly fulfilled that formidable task.[19] On the question of what would be a reasonable amount of indirect costs to allocate to residential default service, the RD declines to address whether PECO carried its burden of proving that the answer is zero. Also, through a failure to address the reasonableness of PECO's allocation of all indirect costs to one segment of its business, and its allocation of no indirect costs to the other segment of its business, the OALJ does not hold PECO to the requisite burden of proof.

In addition, the RD mischaracterizes NRG's proposal, describing it as involving a reallocation of a portion of PECO's "fixed costs" from residential distribution service to residential default service.[20] Whereas NRG identified "indirect costs" as common or shared costs across operating segments, which may vary by volume (i.e. customer service costs),[21] "fixed costs" do not vary with volume (i.e. property taxes on a building).[22] Indeed, the costs

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15 RD at 124.
16 RD, Conclusion of Law No. 5.
17 *Burleson v. Pa. P.U.C.*, 461 A.2d 1234, 1236 (Pa. 1983).
18 RD, Conclusion of Law No. 6.
19 RD at 124-130.
20 RD at 128.
21 NRG St. No. 1 at 17-19.
22 *See, e.g., Fixed Utility Distribution Rates Policy Statement,* Docket N. M-2015-2518883 (Proposed Policy Statement Order entered May 23, 2018), at 16-17.

identified in the RD for reallocation from distribution to default service, although characterized as fixed costs, are clearly indirect costs.[23] As a result of this fundamental error in the RD, the minimal rationale offered by the OALJ is flawed.

Further, the RD does not discuss the widely accepted accounting principles that are routinely followed by businesses and organizations to allocate indirect costs to all segments of their operations – principles that were not refuted by PECO or OCA. Indeed, at no point does the RD offer any explanation to support the notion than a public utility can carry its burden of showing just and reasonable rates when it wholly ignores an entire side of its business in the allocation of indirect costs. By failing to hold PECO to the burden of proving the justness and reasonableness of every aspect of the proposed rate increase, the OALJ has ignored legal requirements by which Commission decisions are bound. Moreover, the conclusion that PECO carried its burden of proof is not supported by the RD or the record in this proceeding.

4. *NRG's Presented Evidence and Analysis Tending to Demonstrate the Reasonableness of Its Proposal*

It was sufficient for NRG to present "some evidence or analysis tending to demonstrate the reasonableness" of its proposal.[24] Given that PECO's proposed allocation of indirect costs wholly overlooked the default service side of its business, NRG's evidence and analysis certainly tended to demonstrate the reasonableness of its proposal to allocate some portion of these costs to default service. Further, NRG showed that its proposed cost allocators of revenues and the number of customers, which are commonly used by a wide variety of industries and businesses, including PECO itself, are appropriate. NRG St. No. 1 at 23-30.

NRG Exhibit CP-5 identifies the expense categories that were allocated entirely to residential distribution services, including Distribution Operation, Distribution Maintenance,

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[23] RD at 128. These indirect costs include customer service expenses, sales expenses, A&G expenses, and depreciation & amortization expense.

[24] *Breezewood.*

Customer Accounts, Customer Service, Sales, A&G, Intangible Plant, Transmission Plant, Distribution Plant, General Plant and Common Plant Depreciation/Amortization. NRG St. No. 1 at 16.[25] Of the remaining expense categories that PECO allocated entirely to residential distribution services, Mr. Peterson examined the following amounts of indirect expenses, as shown on NRG Exhibit CP-5:

Expense Category	**Amount Allocated Entirely to Residential Distribution Service ($)**
Customer Service	10,857,163
Sales	793,507
A&G	136,051,164
Intangible Plant	12,689,664
General Plant	11,629,436
Common Plant	24,595,247
Total Pool	196,616,182

NRG St. No. 1 at 17.[26]

As explained by Mr. Peterson, it is illogical to allocate all indirect costs to one segment of a business while allocating none to another separate and distinct side of the business. NRG St. No. 1-SR (Rev) at 20. Yet, rather than considering whether certain costs would be incurred to provide residential default service or using a reasonable allocation method to allocate these costs to both distribution and default service, PECO and the OALJ simply ignore widely accepted accounting principles that are routinely used by businesses for allocating indirect costs. While cost allocation is not an exact science and varying allocation approaches can reasonably be used,

[25] Of these categories, Mr. Peterson did not challenge PECO's allocation of all costs for Distribution Operation, Distribution Maintenance, Outside Services related to Advanced Metering Infrastructure, Transmission Plant and Distribution Plant to distribution service because he viewed those costs as being incurred solely for the purpose of providing T&D services. Also, he accepted PECO's allocation of customer accounts expense since EGSs use PECO's utility consolidated billing services. However, he noted that if the billing and collection functions were to shift to EGSs for their customers, an allocation adjustment to PECO's costs in this regard may be necessary. NRG St. No. 1 at 23.

[26] More details about the expense items under each of these categories are set forth in NRG St. No. 1 at 19.

including those advanced by NRG in this proceeding, it is imperative that some reasonable level of indirect costs are allocated to residential default service. Simply stated, the answer is not zero.

As support for his views as to the proper allocation of these indirect expenses, Mr. Peterson described the "concept of full absorption costing, which is a term of art in financial accounting that refers to the assignment of all reasonable costs to an activity. Full absorption costing typically involves allocations of common costs between activities." NRG St. No. 1 at 18. Stated differently, the concept of full absorption costing is a guiding principle justifying cost allocation, not a specific methodology used for allocation. Following this guideline, all reasonable costs associated with a product or activity should be allocated, including indirect costs. NRG St. No. 1-SR (Rev) at 26-27.

Further, as Mr. Peterson noted, the allocation of shared costs to different businesses or business units is not a novel concept. Companies consistently allocate indirect expenses across business units and cost centers. It is noteworthy that even the Commission itself incurs indirect costs that are not directly attributable to specific industries for purposes of determining regulatory assessments on the entities it regulates. As a result, those indirect costs are allocated to all industries.[27] Mr. Peterson testified that the "concept is the same for any business or organization." NRG St. No. 1-SR (Rev) at 39. In Mr. Peterson's experience, "nearly every business with complex operations incurs indirect expenses of the type" he has identified as "needing to be reallocated to default service." NRG St. No. 1-SR (Rev) at 20. As he explained, it "is common and prudent business practice to allocate all reasonable costs to any business or business unit so that management can better understand the implications of running that line of business. From an accounting perspective, it is appropriate to allocate indirect costs across all segments or divisions of a business' operations." NRG St. No. 1-SR (Rev) at 20.

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27 66 Pa. C.S. § 510(b)(1)-(2).

Noting that a "single universal convention for cost allocations does not exist," Mr. Peterson testified that "numerous cost allocation methods are commonly used and widely accepted to determine the entire cost of an activity." NRG St. No. 1 at 18. In simple terms, cost allocations are the methods or ratios used to apportion costs. He identified common cost allocation drivers as including revenues, number of customers, and labor hours.[28] As Mr. Peterson noted, "[j]udgment is required to determine the reasonableness of a cost allocation methodology for a given activity." NRG St. No. 1 at 18. Importantly, regardless of what the most ideal allocation approach might be, some reasonable level of indirect costs must be allocated to residential default service. While reasonable minds can certainly disagree about the proper methods that should be used to allocate indirect costs across different functions or segments of a business, PECO has failed to demonstrate that its approach of allocating *no* indirect costs to residential default service is reasonable.

Yet, none of this testimony, which was offered by a court-appointed expert witness on matters of forensic accounting and cost allocation, was even considered by the OALJ. Rather than extend any level of respect for the expertise of Mr. Peterson as a forensic accountant and certified public accountant, which PECO did not challenge, the RD simply notes: "Mr. Peterson acknowledged that he has never allocated public utility costs for ratemaking purposes."[29] It is irrelevant that Mr. Peterson has not previously allocated public utility costs for ratemaking purposes. Mr. Peterson was presented by NRG in this proceeding as a forensic accounting expert witness, who has on numerous occasions performed analyses across a variety of industries

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[28] Although the RD does not identify the allocators proposed by NRG's witness, which involves a hybrid approach using both the number of customers and percent of revenues, it should be noted that PECO has argued that labor is the proper allocator for most A&G expenses. Importantly, Mr. Peterson did not did not disagree with the allocation of costs on the basis of labor as between customer classes. However, since PECO did not take the additional step of allocating costs as between distribution service and default service within the residential classes, and labor information is not available at that level, it is necessary to rely on other typical allocation factors. NRG St. No. 1-SR (Rev) at 28.

[29] RD at 128.

of the proper way to allocate costs across different segments or lines of a business.[30] Rather than dismissing Mr. Peterson's cost allocation expertise because it was developed through work with other industries, the OALJ should have embraced the fresh perspective and experience introduced into this proceeding by Mr. Peterson's testimony.

For over twenty years, the Commission has expressed a desire to get these cost allocations correct so that EDCs are recovering default service costs through the PTC and not continuing to recover such costs through distribution rates.[31] Both informally and formally, the Commission has invited interested parties to present evidence in distribution rate cases to show how this goal can be accomplished.[32] In response, NRG stepped up to the plate, engaged legal counsel to represent it in PECO's base rate proceeding, fought – over PECO's opposition – to be granted full intervention status in this proceeding, engaged a forensic accountant to conduct a study and provide expert witness testimony, submitted both direct and surrebuttal testimony, participated in the evidentiary hearings and filed main and reply briefs. As such, NRG deserves to have its position, its rationale and its proposal thoughtfully considered and fully analyzed by the Commission – not dismissed by a handful of pages that are primarily focused on accepting PECO's position, rationale and proposal.[33]

5. *NRG's Proposal Should Be Adopted*

When a reasonable portion of PECO's indirect costs is reallocated from residential distribution service to residential default service, consistent with widely accepted accounting

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30 NRG MB at 20-27.

31 *See, e.g., 1997 Restructuring Order* at 53-62.

32 *See, e.g, Default Service and Retail Electric Markets, Docket No. M-00072009 (Final Policy Statement entered May 10, 2007), 37 Pa. B. 5019 ("Policy Statement Order"),* at 8-9; *Investigation of Pennsylvania's Retail Electricity Market: End State of Default Service*, Docket No. I-2011-2237952 (Order entered February 15, 2013) ("*RMI End State Order*"), at 21.

33 Code Section 335(a) provides that "[o]n review of the initial decision, the commission has all the powers which it would have in making the initial decision." 66 Pa.C.S. § 335(a). The Commission is free to wholly disregard and supersede the RD. *See, e.g., City of Philadelphia v. Pa. P.U.C.*, 73 Pa. Cmwlth. 355, 361, 458 A.2d 1026 (1983) ("broader grant of power to the Commission...can scarcely be imagined").

principles and standard business practices, PECO's revenues from residential distribution charges, using proposed rates for the FPFTY 2019, would be reduced by $101 million. This would equate to an average reduction in residential distribution charges in the amount of .76 cents per kWh. More specifically, a residential customer using 1,000 kWh per month would see a decrease in his or her monthly distribution charges in the amount of $7.64, which would amount to $91.68 over the course of a year. NRG St. No. 1 at 39.

The effect of this recommendation is to reallocate approximately $101 million from residential distribution services to residential default service and increase PECO's PTC for residential default service by 1.25 cents per kWh, from 7.15 cents per kWh to 8.40 cents per kWh. NRG St. No. 1 at 33-34. This proposal is consistent with the Commission's regulations requiring an EDC's PTC to recover all default service costs that are incurred to serve customers, as well as the requirements to reallocate costs from the distribution rate to the default service rate and implement commensurate reductions in the distribution rate.[34]

Through adoption of NRG's proposal, the information received by residential customers will allow for more meaningful comparisons between PECO's PTC and the prices offered by EGSs, as required by Section 2807(d)(2) of the Public Utility Code.[35] While the result will still not be a perfect apples-to-apples comparison, these adjustments would permit customers to compare prices and services on a more uniform basis and enhance their ability to make informed choices regarding the purchase of electricity services. Such modifications will also reduce the

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[34] 52 Pa. Code § 54.187(e)

[35] 66 Pa.C.S. § 2807(d)(2) ("Information shall be provided to consumers in an understandable format that enables consumers to compare prices and services on a uniform basis"). *See also Guidelines for Use of Fixed Price Labels for Products With a Pass-Through Clause*, Docket No. M-2013-2362961 (Order entered November 14, 2013), at 28-29 (Commission stressed the importance of consumers being able to make accurate and fair comparisons to make informed shopping decisions).

subsidization of default service by distribution service customers and improve the overall functioning of the electric retail competitive market.[36]

As to the RD's criticism that NRG's proposal was limited to the residential class, it is not a valid basis upon which to reject the proposal.[37] Although the focus of Mr. Peterson's testimony was on PECO's distribution and default service for the residential (Rate R) and residential heating (Rate RH) classes, which are referred to throughout his testimony as the "residential" classes, customers or services, his analysis could just as easily be applied to commercial and industrial customer classes with similar outcomes, if the Commission so desires. NRG St. No. 1-SR (Rev) at 41.

B. EXCEPTION NO. 2: THE RD IMPROPERLY CONCLUDES THAT THE PTC RECOVERS ALL COSTS OF PROVIDING DEFAULT SERVICE

1. The Commission's Directives Are Clear that the PTC Should Recover All Costs of Providing Default Service

The Commission's regulations establish requirements for the design of default service rates and the recovery of reasonable costs. Specifically, they require the PTC to "be designed to recover all default service costs, including generation, transmission and <u>other default service cost elements</u>, incurred in serving the average member of a customer class."[38] The regulations further prohibit an EDC from recovering default service costs through the distribution rate. When costs are reallocated from the distribution rate to the default service rate, the regulations mandate that "[t]he distribution rate shall be reduced to reflect costs reallocated to the default service rate."[39]

The Commission clarified this requirement through its Default Service and Retail Electric Markets-Statement of Policy on May 10, 2007 ("Policy Statement") adopted on May 10, 2007,

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36 Measures designed to correct the pricing of default service are particularly necessary given the challenges faced by EGSs due to the PTC often not being "correlated to wholesale energy markets," which can "inhibit consumers' ability to make informed decisions due to the receipt of false or misleading price signals." *RMI End State Order* at 12.

37 RD at 129.

38 52 Pa. Code § 54.187(e) (emphasis supplied).

39 52 Pa. Code § 54.187(e).

which addresses various elements of the default service regulatory framework, including default service program terms, electric generation supply procurement and competitive bid solicitation process.[40] Specifically, the Policy Statement lists the default service cost elements that should be included in the PTC.[41] These elements entail the costs for providing generation service, such as wholesale energy, capacity, ancillary, transmission and congestion costs, as well as applicable taxes and costs for alternative energy portfolio standard compliance. They also include supply management costs (i.e., bidding, contracting, hedging, scheduling and forecasting services), and A&G expenses related to those activities. In addition, the Policy Statement identifies several administrative costs for inclusion in the PTC, including billing, collection, education, regulatory, litigation, tariff filings, working capital, information system, and associated A&G expenses related to default service.[42] The Policy Statement also states that "EDC rates should be scrutinized for any generation related costs that remain embedded in distribution rates."[43]

In adopting the Policy Statement, the Commission indicated that while "utility rates were unbundled into transmission, distribution and generation components as part of the restructuring process, there is a significant concern on the part of the Commission and others that some generation costs have been improperly allocated, or 'embedded' in EDC distribution rates."[44] Since then, the Commission has continued to recognize the possibility of the further unbundling of commodity costs from distribution rates to ensure that PTCs reflect all costs of default service. Specifically, during the Retail Markets Investigation in 2013, the Commission addressed comments suggesting a further unbundling of commodity costs from distribution rates. Noting its agreement with this concept, the Commission said that it "has strived to address these issues

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[40] 52 Pa. Code §§ 69.1801-69.1817.
[41] 52 Pa. Code § 69.1808.
[42] 52 Pa. Code § 69.1808 (a).
[43] 52 Pa. Code § 69.1808 (b).
[44] *Policy Statement Order* at 8-9.

as they have arisen in distribution rate cases."[45] The Commission also stressed that it was not precluded from addressing the further unbundling of commodity costs and distribution rates in another proceeding in the future.[46]

2. *PECO's PTC Does Not Include All Costs of Providing Default Service*

Despite these clear directives from the Commission to ensure that the costs of providing default service are recovered through the PTC and not through distribution charges, the RD wrongfully concludes that because PECO's PTC does include (or has in the past has included) the "types" of costs identified by the Commission, it adequately recovers all costs associated with providing default service.[47] Including the "types" of costs in the PTC that are required by the Commission does not translate to including the proper amount of costs, particularly when some specific cost components have been omitted or are significantly under-stated. Based on the analysis performed by NRG's witness, it is clear that the PTC does not accurately reflect the costs that are incurred to provide default service to customers who are not served by an EGS.[48]

a. PTC Methodology is Flawed

PECO's PTC methodology is shown in NRG Exhibit CP-13. The list of components that are included in the PTC demonstrates that indirect expenses incurred to operate a business have been omitted from PECO's methodology. Of particular note, the administrative cost factor in PECO's PTC methodology is very narrow and only reflects "the costs of the auction or Request for Proposal (RFP) monitor, consultants providing guidance on the development of the procurement plan, legal fees incurred gaining approval of the plan, and any other costs associated

45 *RMI End State Order* at 21.

46 *RMI End State Order* at 21.

47 RD at 126-128.

48 The RD erroneously accepts PECO's PTC formula due to its prior approval by the Commission. RD at 128. Notably, no party previously raised the issues that NRG has highlighted in this case. NRG St. No. 1-SR (Rev) at 12-13. Further, this observation overlooks the Commission's commitment to getting these allocations correct.

with designing and implementing a procurement plan."[49] While the Policy Statement identifies administrative costs as a component of the PTC, PECO only includes "administrative costs that are associated with the wholesale power supply contracts," while not including administrative costs more broadly related to the provision of default service. PECO Statement No. 9-R at 6.

By only including administrative costs that are directly associated with the procurement of wholesale power supply, PECO is inappropriately viewing the provision of default service as entailing only the procurement of energy for non-shopping customers. However, as evidenced by PECO's most recent default service proceeding, default service is broader than the procurement of energy.[50] NRG St. No. 1-SR (Rev) at 7. As Mr. Peterson explained, in serving default service customers, PECO necessarily incurs administrative costs in connection with numerous aspects of its business. Beyond procuring default service supply, PECO needs to rely on numerous resources to make default service available to consumers. NRG St. No. 1-SR (Rev) at 7. Mr. Peterson provided additional details in support of his statement as follows:

> For example, supporting default service requires a call center infrastructure and employees to maintain appropriate customer service. An information technology infrastructure is necessary to support these aspects of PECO's business and this infrastructure requires appropriately trained personnel to maintain and upgrade it. Costs are incurred to maintain and operate office space for the employees supporting default service. These employees are supported through a corporate structure addressing administrative and human resources issues that incurs costs. These employees also need access to office supplies and other accounting and auditing services. Administrative costs are incurred to communicate with default service customers including, but not limited to, expenses related to printing and postage. Working capital (e.g. the cost of money) must also be available to support the purchase of default service supply for customers in advance and receive payment from those customers at a later date. Costs related to outside and inside legal personnel are needed to comply with the regulatory rules and requirements related to default service. In short, a business that projects over

[49] See NRG Exhibit CP-3 at N-11 (PECO's PTC Sample Calculation Methodology for June-August 2017, page 3). Source: https://www.peco.com/SiteCollectionDocuments/Residential.pdf . The administrative cost factor was 0.00 cents per kWh from June through August 2017. Historically, it has been higher at 0.04 cents per kWh from June through August 2013 and 0.01 cents per kWh from December 2015 through February 2016. In all instances, the administrative cost factor did not account for a significant portion of the PTC. NRG St. No. 1 at 35.

[50] *Petition of PECO Energy Company for Approval of its Default Service Program for the Period from June 1, 2017 through May 31, 2021*, Docket No. P-2016-2534980 (Order entered December 8, 2016).

$637 million in annual default service revenues could not operate without incurring administrative costs of the type and magnitude that I have identified.

NRG St. No. 1-SR (Rev) at 7-8.[51]

PECO explained that only when IT costs relate specifically to implementation of the default service plan have they been included in the PTC. PECO Statement No. 9-R at 6. That standard, however, is not consistent with the Policy Statement, which identifies IT costs for inclusion in the PTC and does not limit the inclusion of such costs to only IT upgrades necessary to implement the default service plan. Rather, the Policy Statement indicates that IT costs "related to default service" should be included in the PTC. As Mr. Peterson testified, IT costs are an integral part of the ability of PECO to provide default service. Therefore, it is his view that a reasonable portion of PECO's IT costs should be included in the PTC since it would be impossible for PECO to provide default service to over one million customers without incurring IT costs. NRG St. No. 1-SR (Rev) at 11.

With respect to regulatory costs and litigation costs, PECO indicated that only those costs "associated with PECO's default service plans are recovered through the PTC," and identified no other regulatory and litigation costs associated with the provision of default service. PECO Statement No. 9-R at 6. Since PECO would necessarily incur some level of regulatory costs and additional litigation costs associated with the provision of default service that are not reflected in the PTC, Mr. Peterson opined that it is necessary to allocate a reasonable portion of those indirect costs to default service. NRG St. No. 1-SR (Rev) at 9. By including only regulatory costs and litigation costs that are associated with PECO's default service plans in its current PTC, PECO is overlooking the fact that it incurs other regulatory and litigation costs related to the provision of default service. For instance, PECO files comments with the Commission

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[51] Mr. Peterson recognized that PECO's PTC already contains a component for working capital. However, he noted that the amount currently in the PTC is only $813,535. NRG CP-20 (PECO Responses to NRG-III-1 and NRG-III-2).

related to proposed retail market enhancements, including comments urging the Commission to keep EDCs in the default service role[52] and opposing an EGS proposal to implement supplier consolidated billing.[53] Both sets of comments related specifically to PECO's DSP's functions.

According to PECO, "[c]osts associated with educating customers about retail market enhancements not paid for by EGSs may be included in the PTC." PECO Statement No. 9-R at 7. Again, the Policy Statement clearly provides that education costs should be, not may be recovered through the PTC. Whether education costs are directly related to a retail market enhancement is not the standard that PECO should employ. Education activities can take many forms including call center representatives responding to inquiries about electric choice, for which those representatives need to be trained. In addition, PECO engages in extensive education, awareness and marketing activities in connection with their energy efficiency and conservation ("EE&C") programs[54] – all of which give PECO an opportunity to educate consumers about default service. Therefore, it is unreasonable for PECO to include no education costs in the PTC. NRG St. No. 1-SR (Rev) at 11-12.

b. Most Recent PTC Has Zero Costs for Education, Regulatory and Information System

The specific elements of PECO's PTC for the most recent quarter are set forth in NRG Exhibit CP-20 (Rev). Notably, the most recent PTC includes zero costs for Education, Regulatory and Information System. NRG Exhibit CP-20 (Rev); Tr. 446. This means that PECO is supposedly operating a business upon which over one million residential customers rely for generation supply service without incurring any IT, regulatory or education costs. It is

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[52] *Investigation of Pennsylvania's Retail Electricity Market: End State of Default Service*, Docket No. I-2011-2237952 (PECO Comments filed December 10, 2012).

[53] *Petition of NRG Energy, Inc. for Implementation of Electric Generation Supplier Consolidated Billing*, Docket No. P-2016-2579249 (PECO Comments and Answer filed January 23, 2017).

[54] *See* NRG Exhibit CP-22 (PECO Response to NRG-III-8).

unfathomable to accept the notion that PECO incurs no IT, regulatory or education costs to provide essential electricity services to two-thirds of its residential distribution customers.

Additionally, the current PTC includes 0.005 cents per kWh for administrative costs, which total only $118,314.[55] As Mr. Peterson testified, "[t]he significance of a total of $118,314 in administrative costs in the current PTC to support a business that provides default service to over one million customers is that it single-handedly shows the absurdity of PECO's misallocations as between distribution and default service. PECO forecasts annual A&G costs of over $136 million for the residential rate class; $118,314 is less than 1 percent of the forecasted amount." NRG St. No. 1-SR (Rev) at 8.

Astonishingly, PECO's PTC for the last quarter reflects *negative* A&G expenses related to default service. NRG Exhibit CP-20 (Rev). While PECO acknowledged this negative expense category, no testimony was offered to explain this absurd result. Tr. 446. It would not be possible to run any business, let alone a business that is selling 8.6 billion kWh of electricity and generating hundreds of millions of dollars, with negative A&G expenses.

It is also noteworthy that PECO uses an Energy Acquisition team ("EA"), consisting of nineteen employees, who perform functions necessary to support electric and gas customer choice. Yet, PECO does not allocate these costs to default service. Rather, they are recovered through distribution rates because PECO views these services as part of delivering energy to both shopping and default service customers. Tr. 440-441. While PECO may find it more convenient to combine these tasks of allocating system throughput among suppliers and acquiring default service supply, the acquisition of energy supplies is clearly allocable to default supply service under traditional ratemaking principles of cost causation. The fact that PECO allocates none of

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[55] This calculation is shown on Attachment III-1(a) and is derived by adding together the amounts of $71,977 (Supply bidding & Contracting), $25,398 (Administrative and General Expenses related to Supply management costs), and $32,630 (Litigation), and then subtracting from that total the amount of $11,691 (Administrative and General Expenses related to Default Service). Tr. 447-448.

the EA costs to default service is further evidence of its lopsided approach of allocating a disproportionate amount of costs to distribution service.[56]

C. <u>EXCEPTION NO. 3: THE RD WRONGFULLY DISREGARDS THE COMMISSION'S STANDARD FOR UNBUNDLING</u>

As part of its restructuring plan filed on April 1, 1997, PECO presented its cost-of-service allocation study and functionalized cost study by class-of-service and a detailed analysis of functional assignment of costs among the production (generation), transmission and distribution functions. In its *1997 Restructuring Order*, the Commission addressed the identical problem as has been raised by NRG in this proceeding and established the standard that should be used in unbundling charges for generation, transmission and distribution services. However, due to a fundamental misunderstanding of the purpose of the restructuring proceeding, the OALJ has wholly disregarded the standard developed by the Commission, which considers how PECO's costs would be allocated if it were to functionally separate itself into two distinct divisions to provide distribution services and generation services.

1. <u>*Commission Established Applicable Standard for Unbundling in PECO's Restructuring Proceeding*</u>

During litigation, OCA and other parties argued that PECO had misallocated costs among the three unbundled services. As OCA's witness noted, A&G expenses comprised a substantial percentage of the costs being challenged, and that costs "in these accounts are not easily identifiable with particular operating functions. They include salaries and office supplies for personnel in administrative functions such as human resources, legal, or accounting. These

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[56] PECO's explanation of its EA team was first introduced during oral rejoinder testimony presented at the August 21, 2018 hearing. Therefore, NRG had no opportunity to respond or conduct discovery on this PECO practice, which raises questions about compliance with the Standards of Conduct of the Federal Energy Regulatory Commission ("FERC") relating to the barrier that must exist between transmission and wholesale merchant functions, 18 CFR § 37.4(a), and may warrant referral to FERC by the Commission under Code Section 2811(d), 66 Pa.C.S. § 2811(d). *See* <u>https://corporate.findlaw.com/litigation-disputes/ferc-standards-of-conduct-and-business-support-functions.html</u>.

activities contribute to the generation function as well as distribution and transmission. Generation planners and marketers make use of these administrative functions and expenses."[57]

Upon review of PECO's cost allocation methodology, the Commission found that it was deficient because it "misallocated costs" by failing "to properly assign certain general costs to generation and allocated 100 percent of those costs to T&D."[58] As the Commission stated, "[s]imply put, in its original filing, PECO assigned the vast majority of Administrative and General ("A&G"), Overhead and general plant expense to its T&D rates. This assignment occurred without regard to whether there is a continuing generation component in that cost."[59]

In addressing this problem, the Commission concluded that PECO's unbundling should produce results that resemble the way its costs would look if it operated a functionally separate default service division. The direct quote from the *1997 Restructuring Order* is as follows:[60]

> In reaching our determination on this issue, we are persuaded by the OCA witness who stated:
>
> > Even if the Company does need the same number of people in the payroll department and other A&G accounts, their cost should be allocated to the functions they support. It is simply incorrect to allocate these dollars entirely to T&D.
> >
> > Unbundling costs should produce results that should look like what functional costs would be if PECO were to separate itself into functionally separate divisions. Clearly the generation division would require administrative and general services.

Even after PECO revised its proposal, the Commission found that "PECO's allocations still improperly allocate costs to its T&D services rather than properly reflecting that a

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57 *1997 Restructuring Order* at 60, quoting OCA St. No. 5, pp. 4-5.

58 *1997 Restructuring Order* at 53.

59 *1997 Restructuring Order* at 53. Specific accounts identified by the Commission as having been improperly assigned only to T&D included: Account 920 (A&G Salaries); Account 921 (Office Supplies and Expenses); Account 923 (Outside Services Employed); and Account 935 (Maintenance of General Plant). 1997 Restructuring Order at 54.

60 *1997 Restructuring Order* at 58.

generation component exists in those costs."[61] Rejecting PECO's revised proposal, the Commission emphasized that it must "ensure that there is an appropriate allocation of all costs among generation and T&D."[62] To address the shortcomings in PECO's proposal, the Commission adopted the methodology and adjustments that OCA had presented in surrebuttal testimony and reduced the T&D rate accordingly.[63] The Commission permitted PECO to recover the difference of $460 million through the competitive transition charge,[64] which was the mechanism that was used for the recovery of PECO's stranded costs and expired in 2010.[65]

The Commission also highlighted a concern regarding the level of A&G expenses, which it said were not clearly generation (energy production) or clearly T&D (wires). However, since no party had presented any competing evidence relating to those cost levels, the Commission accepted them. In doing so, the Commission stated: "[w]e note, however, that nothing precludes any person from later challenging PECO's T&D rates under any applicable section of the Public Utility Code."[66] Similarly, the Commission did not modify PECO's proposed allocations for uncollectibles, customer accounts, customer service and sales. Nonetheless, the Commission stressed that as functions continue to be unbundled, PECO's rates may be reexamined to determine if they provide for charges which encompass generation or other unbundled services.[67]

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[61] *1997 Restructuring Order* at 54.

[62] *1997 Restructuring Order* at 57.

[63] *1997 Restructuring Order* at 59-61.

[64] *1997 Restructuring Order* at 62.

[65] *See Petition of PECO Energy Company for Approval of Its Default Service Program*, Docket No. P-2008-2062739 (Order entered June 2, 2009).

[66] *1997 Restructuring Order* at 50.

[67] *1997 Restructuring Order* at 61. NRG recognizes that the 1997 Restructuring Order was not implemented by PECO but was instead replaced by a joint settlement later filed by the parties. However, the joint settlement did not disturb details regarding cost allocation and produced a system average shopping credit of 4.46 cents per kWh, which mirrored the result of the *1997 Restructuring Order*. *See* Order entered May 14, 1998.

2. *NRG's Proposed Approach Mirrors that Taken by the Commission in PECO's Restructuring Proceeding*

Consistent with the approach taken by the Commission in PECO'*s* 1997 restructuring proceeding, NRG proposes in this base rate proceeding to reallocate indirect expenses in a way that more accurately reflects the costs that PECO incurs to support all of PECO's residential operations, including both default service and distribution service. As the OCA argued in 1997, and the Commission agreed, Mr. Peterson opined here that "PECO's expenses should be allocated in a way that resembles the costs that PECO would incur if it operated a separate default service division. PECO's expenses to operate such a division would necessarily include indirect costs of the type I am identifying in this testimony." NRG St. No. 1 at 18.

Observing that independent functions must be performed for each of these services, which are separate and distinct, Mr. Peterson explained that "both lines of the business necessarily must rely on shared or common services, such as information technology, regulatory costs and litigation costs. In order to ensure that each business line supports the costs that are incurred for these shared or common services, it is necessary to allocate these costs to both lines of the business." NRG St. No. 1-SR (Rev) at 19-20.

Mr. Peterson further explained that a functionally separate default service division would necessarily incur costs associated with administrative salaries, office supplies, property insurance, regulatory commission fees and other A&G expenses. NRG St. No. 1 at 20. Similarly, the expenses that fall under the category of outside services employed within A&G expenses, including executive, financial, human resources, legal, real estate, etc., are all "common business expenses that are critical to day-to-day operations." NRG St. No. 1 at 20-21. Mr. Peterson unequivocally concluded that "[i]f PECO had a separate division providing default service, it would necessarily incur costs in all of these areas." NRG St. No. 1 at 21.

3. *The RD Wholly Disregards Commission's Rationale in PECO Restructuring Proceeding*

a. Introduction

In recommending rejection of NRG's request for the same relief that OCA sought and was granted in 1997, the RD finds that the restructuring proceeding "separated generation from transmission and distribution" and "did not divide costs with an understanding of what it would cost to provide default service."[68] Further, the OALJ was persuaded by PECO's argument that the 1997 restructuring proceeding involved the actual separation of PECO's generation business from its distribution business, whereas here NRG is asking the Commission to address a "hypothetical separation of functions that PECO performs" as a distribution company. Based on PECO's characterization of the purpose of the 1997 unbundling proceeding, the RD finds that NRG's reliance on language in the 1997 Restructuring Order is misplaced.[69]

As demonstrated below, the RD's disregard for the Commission's 1997 Restructuring Order is in error because the OALJ's rationale is based on a fundamental misunderstanding of the purpose of the restructuring proceeding. Importantly, it most definitely did not involve an *actual* separation of PECO's generation business from its distribution business. Rather, a key purpose of the restructuring proceeding was to review PECO's COSS from the standpoint of determining a proper unbundling of generation and T&D charges. As with any study involving the proper allocation of costs, the *1997 Restructuring Order* necessarily entailed a hypothetical calculation of what PECO's costs would look like if it were to separate itself into functionally separate divisions to provide distribution services and generation services. While the "default service" term had not yet been developed, a review of the *1997 Restructuring Order* reveals that generation service provided to customers who were not served by an EGS was precisely the

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68 RD at 129-130.

69 RD at 129-130.

same service that the Commission now refers to as default service. Therefore, contrary to the RD, a primary purpose of the *1997 Restructuring Order* was to establish am appropriate "shopping credit," now known as the PTC, for customers to use when comparing default service provided by PECO to offers for generation service that were available from EGSs in the competitive retail market – the exact exercise NRG's witness has conducted in this proceeding.

b. Purpose of 1997 Restructuring Proceeding

The RD does not properly characterize the purpose of the 1997 restructuring proceeding. Importantly, the Commission did not address the "actual separation" of PECO's generation business from its distribution business. Rather, the express purpose of the restructuring proceeding was to review PECO's unbundling of rates, competitive transition charges and specific tariff provisions to ensure customers have direct access to all licensed EGSs. Further, PECO requested recovery of $6.8 billion of transition and stranded costs. Finally, PECO asked for approval of a plan to meet its universal service obligations, of a mechanism to recover the costs of its universal service obligations, and of a proposed consumer education program.[70]

A subject of the *1997 Restructuring Order* was a Joint Petition for Partial Settlement, which addressed the following issues: (1) stranded investment and securitization; (2) the CTC/intangible transition costs recovery method, recovery from self-generators, and reconciliation; (3) rate unbundling, cost of service, and treatment of special contracts; (4) universal service, cost recovery for universal service, and suppliers of last resort obligations; (5) impact on community and economic development; as well as (6) consumer education.[71] A key provision of the Partial Settlement was that PECO agreed to transfer its generating operations to a separate corporate affiliate.[72]

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70 *1997 Restructuring Order* at 2.
71 *1997 Restructuring Order* at 5.
72 *1997 Restructuring Order* at 12.

Citing a number of concerns, the Commission denied the Joint Petition for Partial Settlement. In rejecting the Partial Settlement, the Commission specifically addressed the statutory requirement for the unbundling of charges for generation, transmission and distribution. Finding that the Partial Settlement's transmission and distribution rate of 3.11 cents was not just and reasonable, the Commission said it violated the statute because it "includes generation costs of PECO."[73] Having denied the Partial Settlement, the Commission went on to render a decision on the restructuring application, which did not include a proposal for the actual separation of PECO's generation business from its distribution business, as suggested by the RD. In ruling on the restructuring plan, the Commission determined an amount of transition and stranded costs that PECO would be permitted to recover through the competitive transition charge ("CTC").[74]

c. Development of Shopping Credit

The Commission then explained that it was establishing for the first time an unbundled T&D rate for PECO consumers. Shopping customers would only pay the T&D rate and the CTC to the EDC. The addition of the T&D rate and the CTC produced a sum of charges that when compared to the customer's rate in effect as of January 1, 1997, gave rise to the concept of a "shopping credit." The Commission further described the process by which it was obligated to unbundle PECO's rates into generation, transmission and distribution components as fundamentally a ratemaking process, in which the Commission was called upon to determine the company's total cost of service (including capital costs), to properly allocate those costs among the generation, transmission and distribution portions of the company's operations, and to

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73 *1997 Restructuring Order* at 29.

74 *1997 Restructuring Order* at 42. NRG recognizes that the *1997 Restructuring Order* was not implemented by PECO but was instead replaced by a joint settlement filed by the parties. However, the joint settlement did not disturb details regarding cost allocation and produced a system average shopping credit of 4.46 cents per kWh, which mirrored the result of the *1997 Restructuring Order*. *See* Order entered May 14, 1998.

translate those costs into individual rates."[75] The Commission further observed that these "are traditional ratemaking functions as exercised by the Commission since its inception in 1913."[76]

The major difference cited by the Commission was that "once the generation-related costs and rates are developed, the company's customers will be able to choose alternative suppliers for the generation portion of their electric service."[77] "If the customer can contract with a supplier in the competitive market which can provide generation at less than the generation rate determined by the traditional ratemaking process, less the CTC, the customer will experience rate savings."[78] The *1997 Restructuring Order* empowered customers with a "shopping credit" of approximately 4.46 cents per kWh. The shopping credit was the amount that customers were deemed to be paying for what is now known as default service or the PTC.[79]

d. Cost Allocation Process

In the portion of the *1997 Restructuring Order* on which NRG has relied upon during this proceeding, the Commission explained that it was reviewing the unbundling of PECO's rates, which means taking the existing and approved single rate which encompasses all of PECO's services into its separate components of generation, transmission and distribution. References to generation meant the sector of PECO's operations related to the production of energy, while PECO's T&D function encompassed those services used to deliver the energy produced – or "the 'wires' side of an EDC."[80] To derive an accurate unbundled T&D rate, the Commission observed that "costs must be properly assigned to the generation and T&D functions of PECO."[81] The Commission further emphasized that "[o]f particular concern in this phase of the proceeding are those costs and expenses which are not clearly generation (or energy production),

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[75] *1997 Restructuring Order* at 43.
[76] *1997 Restructuring Order* at 43.
[77] *1997 Restructuring Order* at 43.
[78] *1997 Restructuring Order* at 43-44.
[79] *1997 Restructuring Order* at 44.
[80] *1997 Restructuring Order* at 49-50.
[81] *1997 Restructuring Order* at 50.

nor clearly related to the T&D (or 'wires') portion of this case. Those costs are generically referred to as Administrative & General expenses."[82]

Almost every party questioned PECO's cost allocation method for general expense categories which encompassed both generation and T&D. In its analysis, the Commission found that PECO's cost allocation methodology failed to properly assign certain general costs to generation and allocates 100% of those costs to T&D.[83] After adjusting general and overhead expenses with a proper allocation method, the Commission found that the OCA figure was closer to the appropriate rate than that proposed by PECO.[84] Notably, the Commission did not find that the result was perfect – just closer to what it should be.

The Commission further noted that it had not modified proposed allocations for uncollectibles, customer accounts, customer service and sales. In that context, the Commission explained that it "would expect that as functions continue to be unbundled, PECO's rates may be reexamined to determine if they provide for charges which encompass generation or other unbundled services."[85] Having provided specific direction to PECO on its allocation methodology to assist PECO in addressing its modifications, the Commission concluded that PECO's compliance tariff was expected to incorporate those changes.[86]

e. Failure of RD to Address NRG's Position is Flawed

Because of the OALJ's fundamental misunderstanding of the purpose of the restructuring proceeding, the RD does not even discuss NRG's position that PECO's costs should be allocated in a way that resembles how they would be incurred if PECO operated a separate default service

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82 *1997 Restructuring Order* at 50.
83 *1997 Restructuring Order* at 53-60.
84 *1997 Restructuring Order* at 60.
85 *1997 Restructuring Order* at 61.
86 Likewise, this is the approach that is appropriate for the Commission to follow in this proceeding.

division. Rather, the RD echoes PECO's semantics and characterizes NRG's proposal as a "hypothetical separation of functions that PECO performs as a distribution Company."[87]

While PECO previously *generated and sold* electricity and now *procures and sells* electricity, that difference does not alter the fundamental concept endorsed by the Commission in 1997 that the supply side of the business would necessarily incur A&G expenses to operate and that PECO needs to at least consider whether any of these costs support its default service business. NRG St. No. 1-SR (Rev) at 19-20. It is also immaterial that more dollars were at stake during the 1997 restructuring proceeding, due to the income and number of employees that were associated with the generation business at that time.[88] The point is that the Commission was committed to allocating the costs in the most reasonable manner possible – and it was doing so in no less of a hypothetical context than is being proposed here.[89] What was not hypothetical then, and is not hypothetical now, is that actual dollars are involved and they need to be properly allocated among the different segments of PECO's business.

Apparently buying into PECO's argument that categorizes its customers into two buckets – distribution customers and distribution customers who receive default service – the RD refuses to acknowledge that these two segments of PECO's business are separate and distinct. Regardless of the semantics that are used, there is no mistaking the fact that PECO performs significant additional services for distribution customers who receive default service than it does for customers who shop for their supply. Without the services that PECO performs for non-shopping customers, no electricity would even be available to deliver to them. Clearly, the Commission treats default service as its own separate function by requiring EDCs to submit

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87 RD at 130.

88 RD at 130.

89 Moreover, the "costs" are not "hypothetical," as found by the RD at 12, Finding of Fact No. 32. As Mr. Peterson explained, the suggestion that the costs are "hypothetical" is simply a result of the fact that PECO does not directly allocate them to particular functions but rather places them in indirect expense categories. NRG St. No. 1-SR (Rev) at 17.

default service plans and imposing the obligation on EDCs to serve in the default service provider role. Therefore, the RD's analysis of this issue is flawed and should be rejected.

f. Commission Continues to Press for Further Unbundling

It is also noteworthy that the Commission has continued since 1997 to express the need for further unbundling of commodity costs from distribution rates. In adopting the Policy Statement, the Commission indicated that while "utility rates were unbundled into transmission, distribution and generation components as part of the restructuring process, there is a significant concern...that some generation costs have been improperly allocated, or 'embedded' in EDC distribution rates."[90] More recently, the Commission addressed comments suggesting a further unbundling of commodity costs from distribution rates, noting its agreement with this concept and committing to address these issues as they arise in distribution rate cases. The Commission also stressed that it was not precluded from addressing the further unbundling of commodity costs and distribution rates in another proceeding in the future.[91]

D. EXCEPTION NO. 4: THE RD ERRONEOUSLY RELIES ON AN AVOIDED COST THEORY FOR WHICH NO LEGAL SUPPORT HAS BEEN CITED

In its cursory analysis of NRG's proposal, the RD erroneously relies on an avoided cost theory that has no basis in the Public Utility Code or case law for ratemaking or cost allocation purposes. Specifically, the RD reasons that "only avoidable costs, which are those costs that PECO avoids when a customer switches to an alternative supplier, are properly allocated to its PTC."[92] However, the RD references no legal support for its avoided cost theory, which was concocted by PECO and is reserved for other specific situations, such as contracts entered into

90 *Policy Statement Order,* at 8-9.

91 *RMI End State Order* at 21.

92 RD at 128.

under the Public Utility Regulatory Policies Act of 1978 ("PURPA").[93] Specifically, under PURPA, Congress required rates to be based upon what taxpayers would have paid if the utility produced power instead of a qualifying facility.[94] Under that law, the Commission had to determine whether contract costs were at or below full avoided cost.[95] For purposes of ratemaking and cost allocation, the Commission does not consider what costs would be avoided if a utility did not perform certain functions; the avoided cost approach is inapplicable here.

1. The Commission Has Already Rejected Avoided Cost Theory

Indeed, the Commission already rejected this avoided cost theory in adjudicating PECO's restructuring proceeding in 1997. The rationale offered by PECO's witness at that time for certain cost allocations questioned by the parties was that if the costs could not be avoided as a result of the transition to competition and would still be incurred by the future EDC, they should be recovered through regulated distribution rates. As to the A&G expense allocation, PECO made an effort during the rebuttal phase to use "work centers" to separately track costs as being associated with production, transmission, distribution, corporate central services and corporate center. However, PECO continued to propose that these costs be examined to determine whether the same overall cost levels were still appropriate for PECO after all customers could choose their EGS. If the answer was yes, PECO asserted that these costs should be recovered through regulated distribution charges.[96]

Rejecting PECO's "avoided cost" rationale, the Commission found that it must "ensure that there is an appropriate allocation of all costs among generation and T&D."[97] In reaching its determination, the Commission was persuaded that "[i]t is simply incorrect to allocate these

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93 16 U.S.C.S. § 796(18)(A).

94 *Pa. Elec. Co. v. Pa. P.U.C.*, 166 Pa. Commw. 413, 648 A.2d 63 (1994).

95 *GPU Indus. Intervenors v. Pa. P.U.C.*, 156 Pa. Commw. 626, 628 A.2d 1187 (1993).

96 *1997 Restructuring Order* at 55.

97 *1997 Restructuring Order* at 57.

dollars entirely to T&D" because "[u]nbundling costs should produce results that should look like what functional costs would be if PECO were to separate itself into functionally separate divisions. Clearly the generation division would require administrative and general services."[98]

In an attempt to rationalize the use of an avoided cost approach, the RD relies on testimony offered by PECO suggesting that if NRG's allocation method was used, "PECO would run the risk of not being reimbursed for costs it incurs as the customers' distribution company."[99] Importantly, NRG is not proposing that PECO be denied recovery of the amount of $101 million that Mr. Peterson has identified as being misallocated to distribution service. Rather, as he explained, "similar to the way that the riders were developed during the 2010 distribution rate case to capture the transmission service charges and the cash working capital requirements," he proposed that PECO recover this amount through the PTC for default service. NRG St. No. 1 at 31. Specifically, Mr. Peterson recommended that PECO be directed to adjust its PTC at the next quarterly adjustment following the issuance of an order in this proceeding to reflect the reallocation of these costs from distribution service to default service.

As Mr. Peterson noted, the NRG proposal is appropriate given the number of shopping customers today, but that if that changes in the future, PECO would be free to propose modifications. NRG St. No. 1 at 31. It was not incumbent upon NRG to figure out how PECO can ensure the recovery of costs that it incurs to provide distribution service. Importantly, it was up to PECO in the first instance to present cost allocation proposals and to prove that they are just and reasonable. Given the widely accepted accounting principles and common business standards across a variety of industries, under which indirect costs are allocated across all segments of the business, it is clear that PECO is departing from these practices through its

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98 *1997 Restructuring Order* at 58, quoting OCA St. No. 5, p. 5.

99 RD at 128; RD at 10, Finding of Fact No. 15. As NRG has argued, the costs that it proposes to reallocate from distribution to default service are not incurred by PECO as only the EDC, but also as the DSP.

decision to allocate all indirect costs to one segment of its business. Having demonstrated the shortcomings of PECO's proposal, Mr. Peterson used commonly utilized allocators to develop a reasonable approach for allocating a portion of its indirect costs to both segments of PECO's business. It is now up to PECO, if the Commission approves the reallocations proposed by NRG, to determine how to ensure that it recovers the indirect costs that have been reallocated.

In any event, the Commission should disregard PECO's speculation regarding the possibility in the future of a greater percent of customers choosing to receive generation service from an EGS than do so today. Under that hypothetical situation that has no basis in the record, PECO's argument ignores several realities. Initially, PECO is overlooking the fact that it adjusts its PTC on a quarterly basis and could increase it as necessary to recover the reallocated indirect costs. Further, as NRG's witness explained and PECO's witness confirmed, PECO's shopping numbers have been relatively stable for the past five years. NRG St. No. 1-SR (Rev) at 31; Tr. 457. Moreover, nothing would prevent PECO from later proposing modifications to the allocated amounts if the circumstances would materially change. NRG St. No. 1-SR (Rev) at 31. For instance, PECO would have an opportunity in a future distribution rate proceeding to propose an alternative allocation approach or seek approval for a different recovery mechanism, such as an automatic adjustment clause. In short, the possibility of the current and historical shopping situation changing in the future is not a reason to forego fixing the illogical approach that is being followed by PECO today through its allocation of all indirect costs to residential distribution service.

2. *Commission Follows Cost Causation Principles*

It is well-settled that for cost allocation and ratemaking purposes, the Commission is primarily required to follow cost causation principles. Specifically, referring to the cost of providing service as the "polestar," the Commonwealth Court has made it clear that while other

factors may be considered, they cannot be allowed to justify subsidization of one group of customers by another group.[100] Notwithstanding the emphasis on cost causation principles and the importance of avoiding cross-subsidization, PECO allocates all indirect costs assigned to the residential customer classes to residential distribution service, rather than using a reasonable allocation method to allocate these costs to both residential distribution service and residential default service. As a result, PECO's cost allocation analysis has fallen short of industry standards by terminating the process at the customer class level without considering the need to allocate indirect costs within the residential classes as they relate to the provision of distribution service and default service. NRG St. No. 1 at 18.

In contrast to PECO's approach of ignoring indirect costs associated with providing default service, NRG's proposed approach for allocating indirect costs is designed to more closely track the way that costs are incurred to run each portion of the business. NRG St. No. 1-SR at 17. Using PECO's actual indirect expenses for specified cost categories that any business would need to incur and widely-accepted allocators to reallocate these shared or common costs across PECO's two business lines, Mr. Peterson allocated these costs between distribution and default service. As Mr. Peterson testified, "[t]o determine if costs should be allocated to certain business units, one only has to consider whether the business could sustain itself with its current cost structure if it were operated on a stand-alone basis. Clearly, PECO's default service business could not operate for even a single day under its current cost structure if it were operated on a stand-alone basis." NRG St. No. 1-SR (Rev) at 17.

Notably, consistent with Section 510(b)(2), the Commission itself allocates indirect costs to the entities it regulates for purposes of recovering its regulatory expenses, on the basis of

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100 *See Lloyd v. Pa. P.U.C.*, 904 A.2d 1010, 1020 (Pa. Cmwlth. 2006) ("*Lloyd*").

percent of revenues.[101] In fact, recently, when the Commission was authorized by the General Assembly to impose annual fees on EGSs and natural gas suppliers ("NGSs"), it determined to use a different allocation method than revenues and instead found that "a reasonable approach to allocating indirect costs to NGSs and EGSs is to base this allocation on the ratio of NGS/ESG costs to total Commission direct costs."[102] In arriving at this decision, the Commission recognized the need to allocate indirect costs related to the oversight of NGSs and EGSs in a manner that reflects the fact that staff spends time on supplier activities.[103]

Indirect costs – because they cannot be linked to a particular function – cannot be evaluated precisely in a cost causation manner.[104] Nonetheless, Mr. Peterson considered the types of expenses he was reallocating from the perspective of whether they would be incurred to provide default service. Through that process, Mr. Peterson engaged in an in-depth analysis to confirm that these are exactly the types of costs that PECO would incur in providing default service. NRG St. No. 1 at 19-23. It is also important to note that the construction of a cost of service study is not an exact science and there are no precisely right or wrong cost allocation methodologies. Cost allocation is a tool that is used in determining an appropriate rate design. Although cost of service is always an important and normally the primary basis of pricing, judgment and some assumptions must be made; cost of service studies are not perfect or precise.[105] In reviewing postal rates that are required to be based on cost-of-service principles, the United States Supreme Court observed that "[a]llocation of costs is not a matter for the slide-rule. It involves judgment on a myriad of facts. It has no claim to an exact science."[106]

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101 66 Pa.C.S. § 510(b)(2).

102 *Implementation of Act 155 of 2014*, Docket No. M-2014-2448825 (Order entered April 24, 2015), at 5.

103 *Id.* at 5-6.

104 *See In re Actiq Sales & Mktg. Practices Litig.*, 2014 U.S. Dist. LEXIS 98441 (2014) (indirect costs are those that cannot be traced to a product in an economically feasible way but which are required to produce and sell a product.).

105 *Nat'l Ass'n of Greeting Card Publrs. v. USPS*, 462 U.S. 810 (1983).

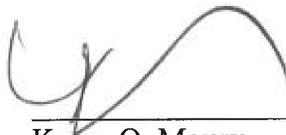
106 *Id.*, quoting *Colorado Interstate Co. v. FPC*, 324 U.S. 581, 589 (1945).

Here, NRG's witness exercised his judgment, based on extensive experience allocating costs, in an attempt to reasonably allocate the indirect costs to the separate distribution and default service functions in a way that is aligned with cost causation principles. By contrast, PECO's allocation of all indirect costs to one segment of its business reflects no attempt to follow such principles. Given the purpose of cost allocation as an attempt to establish rates that reflect the way in which costs were incurred, NRG's approach is far superior to that proposed by PECO and should be adopted by the Commission.

IV. CONCLUSION

WHEREFORE, NRG Energy, Inc. respectfully requests that the Commission grant its Exceptions, modify the Recommended Decision and direct PECO Energy Company to reallocate its indirect expenses, to reflect the level of rate relief that is awarded in this proceeding, in the manner recommended by NRG in this proceeding.

Respectfully submitted,



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